# COMPETITION WATCH

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## VIRGINIA'S PRIVATIZATION PROGRAM RECEIVES HIGH MARKS

In the September 1996 issue of Competition Watch it was reported that the United States General Accounting Office would report its findings on privatization from extensive visits in Virginia, Massachusetts, New York, Michigan, Georgia, and the City of Indianapolis. The GAO has issued its findings in a March 1997 report titled, **"PRIVATIZATION - LESSONS LEARNED BY STATE AND LOCAL GOVERNMENTS"**. The following represents some of the report's results in brief: (the statements in quotations are direct references from the report.)

- Privatization Requires a Champion - "In Virginia, key state legislators and the Governor worked together to introduce new privatization initiatives."
- Implementation Structure Needed to Guide Privatization Efforts - "A formal structure is needed to ensure effective implementation when privatization is introduced. In Virginia, the structure was established jointly by the legislature and chief executive."
- Legislative and/or Resource Changes May Be Needed to Promote the Use of Privatization - "Virginia enacted the Virginia Government Competition Act of 1995, which created a permanent independent state council to promote privatization." (The Commonwealth Competition Council)
- Reliable and Complete Cost Information Needed to Support Privatization - "Virginia introduced a comprehensive cost analysis method to capture the complete costs associated with performing a service or function." (The Council's Cost Comparison Program, "COMPETE")
- Analytical Frameworks - "Indianapolis, Michigan, and Virginia had the most formalized frameworks."

A complete copy of the GAO report can be obtained by calling the Commonwealth Competition Council at (804) 786-0240.

## ESOP STUDY UNDERWAY

The 1997 General Assembly approved Senate Joint Resolution No.284 requesting the Secretary of Administration, in cooperation with Commonwealth Competition Council, to study methods to privatize appropriate state government functions through the development and promotion of employee stock ownership plans (ESOPs). Representatives from both the private sector and Virginia government will (a) examine the current rules, procedures, policies, and limitations of employee stock ownerships plans in Virginia government, (b) examine current and innovative employee stock ownership plans in other states, and (c) determine the necessary level of state financial support for such plans. The findings and recommendations will be submitted to the Governor and the 1998 General Assembly.

**OPPORTUNITIES FOR THE DEVELOPMENT OF PUBLIC-PRIVATE PARTNERSHIPS SIGNIFICANTLY EXPANDED BY NEW IRS REGULATIONS**

The private activity bond regulations issued by the Internal Revenue Service on January 10, 1997 correct the most serious deficiencies of the "management contract" and "change in use" rules and should facilitate utilization of public-private partnerships for projects with outstanding tax-exempt bonds. In response to the private sector's expanding participation in the delivery of public services, the Internal Revenue Service has revised the management contract and change in use rules and once these rules are fully implemented, they should provide a workable set of guidelines which can be relied upon in the development of public-private partnerships.

The basic legal principle, which remains unchanged by the new rules, is that, if arrangements between a governmental and a private entity constitute a "private business use" of 10 % or more of a facility financed with traditional tax-exempt governmental obligations, interest on the debt may become taxable retroactively to the date of issuance. The crucial question for sponsors of public-private partnerships then becomes: can reasonable business arrangements be structured without causing the arrangements to be characterized as private business use.

***Prior Rules***. Under the Tax Reform Act of 1986, government obligations can become taxable if there is more than 10% private business use of a facility financed with tax-exempt bonds. The longest feasible contract term for the operation of a tax-exempt financed infrastructure facility was 5 years, terminable at the election of the governmental entity after 3 years. This short term provided the private operator with no assurance that it could recover the large front-end investment which can be incurred in privatization transactions for concession fees, facility improvements, or significant start-up costs.

***New Rules***. The new IRS rules on management contracts and changes in use are effective immediately. They create new safe harbors providing assurance that private operation or ownership of a facility will not cause the bonds financing the facility to become taxable. **The result of these changes should be a marked expansion of opportunities for the private sector to enter into long-term contracts to operate and manage governmental facilities or buy governmental assets.**

Important features of the new rules are briefly summarized below:

A. Liberalization of Management Contract Rules.

In the newly-issued rules, the IRS created several exceptions to the general principle that a management contract providing for private operation of a public facility results in private business use of the facility. Under the rules, contracts for services incidental to the principal function of the facility, such as contracts for janitorial services and equipment repair, will not be considered private business use of the facility. *The exceptions most likely to be of interest to the sponsors of public-private partnerships link the permissible term of a management contract to the method of calculating the operator's compensation. As a general principle, the more the operator's compensation is based on a fixed fee, the longer the permissible term of the agreement.*

The most favorable treatment is accorded to "public utility property" which includes gas, electric, water supply and wastewater treatment facilities which are subject to governmental rate regulation.

If at least 80% of the compensation under the management contract consists of a periodic fixed fee, the contract can have a term not to exceed the lessor of 20 years or 80% of the useful life of the facility. The following list summarizes the length of contract terms, **for property other than public utility property,** under various compensation arrangements which can be included in a management contract <u>without creating private business use.</u>

| **Maximum Term** | **Method of Compensation** |
|---|---|
| 15 years | 95% periodic fixed fee |
| 10 years | 80% periodic fixed fee |
| 5 years | 50% periodic fixed/capitation fee |
| 3 years | Per-unit fee |

The portion of the compensation not required to be a periodic fixed fee can be in the form of a capitation fee, a per-unit fee, a productivity award, or a share of the facility's gross revenues, but no portion of the compensation can be based on a share of the net profits from the operation of the facility. These new rules should contribute to the development of privatization projects by expanding the permissible term for management contracts and providing flexibility in structuring permissible forms of compensation.

B. <u>Liberalization of Change in Use Requirements</u>.

The new rules permit the obligations to retain their tax-exempt status, despite the sale of the facility to a private party, if specified remedial action is undertaken. The new rules provide that to retain the tax-exempt status of outstanding bonds upon the sale of the facility, one of the following three options must be implemented:

1. The outstanding bonds may be redeemed within 90 days after the sale of the facility or a defeasance escrow may be established if the bonds cannot be redeemed within 90 days after the sale. (Defeasance is a technique used to avoid retiring low-interest rate debt. Instead, the bond issuer purchases U.S. Treasury bonds earning a higher interest rate and pledges the Treasury bonds as collateral against the debt it owes).

2. If the consideration for the sale of the facility is exclusively cash, the issuer may expend the sale proceeds for a governmental purpose within 2 years of the sale.

3. After the sale, the facility may be used for a purpose which would permit the bonds to be considered qualified 501(c)3 bonds or exempt facility private activity bonds if the requirements applicable to the new bond application, such as volume cap and public approval, are satisfied.

The new change in use rules are an improvement in <u>two</u> important respects: First, they are now available for all facilities with outstanding governmental obligations, not just for facilities with bonds outstanding for 5 years as was the case under the former rules. **This change expands significantly the number of projects for which a public-private partnership is now feasible.** Secondly, the amount of bonds to be defeased or required to be allocated to alternative governmental uses on the sale of the facility is now limited to the lesser of the proceeds from the sale or the amount of the outstanding bonds.

**Conclusions**: The new rules will provide a degree of certainty and specificity which has been missing from the public financial markets in recent years. The increase in the maximum permissible term for management contracts and the expansion of the number of projects able to access the change in use rules will simplify the structuring process for many public-private partnerships, and will make tax-exempt financing available for a greater number of projects. The combination of these factors should result in public-private partnerships becoming an increasingly attractive alternative for the delivery of traditional public services and will create substantial new efficiencies in the delivery of infrastructure services, by:

- Allowing major savings in capital project delivery, as well as in O & M;
- Creating greater out-year price predictability for infrastructure services;
- Rewarding long-term thinking by all parties to a transaction;
- Integrating authority for major functions under one responsible party, and
- Making deferred maintenance impossible (by building it into the contract price)

*This article summarizes a complex set of regulations and related revenue procedures and should not be relied upon without consulting with counsel.*

## PENNSYLVANIA'S PLAN TO PRIVATIZE STATE STORES

Pennsylvania is following the trend in recent years of "control" states privatizing their distilled spirits monopolies. On March 19,1997, Governor Tom Ridge of Pennsylvania unveiled a responsible plan to close Pennsylvania's government-run liquor stores, replacing them with a private system that will be more consumer friendly, while generating hundreds of millions of dollars to invest in an endowment for Pennsylvania's future.

Ridge said in announcing the plan, "government is here to serve the people, not to serve them alcohol. Its time to sell Pennsylvania's state liquor stores." Ridge said his plan, while ending government retail sales, still reflects Pennsylvania's conservative views on alcohol. The plan retains tight controls on the availability of alcohol, and steps up the penalties for irresponsible use -- particularly, for sales to those under age 21.

The proceeds from privatization -- estimated to be $*605 million* over the next 10 years, after current revenues are replaced -- will first be used to help state-store employees. The plan sets aside $20 million for employees, including an unprecedented per employee $2,000 tax credit for prospective employers to hire every full-time employee. They can offer that credit to any prospective employer.

Governor Ridge proposes that $57.5 million of the proceeds will be used to enhance alcohol education and enforcement initiatives. The remaining proceeds, $517 million over 10 years, will be split between two new initiatives. <u>Seventy-five percent</u>, or $388 million, will be invested in a Better Communities Fund, to build local community projects approved by the General Assembly. The bulk of these proceeds will be invested in an endowment, so that the proceeds from privatization will benefit Pennsylvanians forever, Ridge said.

<u>Twenty -five percent</u> will be invested in new Pennsylvania Community Service Scholarships. The new program will award, every year, at least 4,000 four-year, $1,000 per year scholarships to high school seniors in every Pennsylvania graduating class.

Under the Governor's plan the state will retain control of the wholesale system, but close the 654 government wine and spirits stores. Instead, the state will sell 757 franchises, each of which will be sold to the highest responsible bidder. The 757 new stores equals the historic maximum under the state-store system. The franchisees will pay up-front fees for their 10-year franchise, and also recurring annual fees. Any responsible bidder will have the opportunity to buy a franchise, but no buyer can own more than 10 percent of the stores statewide, nor more than 40 percent of the stores in a locality. It is estimated that total proceeds, including proceeds from the ongoing wholesale system, will be $*3.2 billion* over 10 years.

The Pennsylvania Liquor Control Board will continue to regulate licensees, and the Pennsylvania State Police will continue to enforce state liquor laws. Stores will not be permitted near schools and churches, and communities will retain their right to be "dry" if the residents so choose.

The plan proposes to reduce the "wholesale" mark-up on wine and spirits, to put downward pressure on prices. The franchisees will be granted greater flexibility in their operations. Unlike state stores, they could operate on government holidays and hours can be expanded. However, all-night stores and Sunday sales will be prohibited.

In concluding his proposal, Governor Ridge states that his common sense plan gets government out of the business of selling alcohol, but enhances its role in alcohol enforcement, regulation and education.

## PRIVATIZATION BRIEFS

**Welfare Reform Presents New Privatization Opportunities -** As states continue to grapple with welfare reform, there is a growing trend toward using private companies to implement welfare reform. Federal welfare legislation passed last August allows states considerable flexibility in using private contractors to deliver welfare services. In **California**, counties are allowed to enter into performance-based contracts with nonprofit or for-profit companies to operate all or parts of their welfare system. In **Milwaukee County, Wisconsin,** welfare applicants will be screened, trained, and placed in jobs by a private company. **Texas** has the boldest proposal to date**.** It has put out for bid a five-year contract to run the entire state welfare system. The contract will pay $500 million to manage the states's 690,000 welfare recipients. The winning bidder will take over all welfare services, including determining eligibility and making payments.

**IRS Contracts Out Inventory Control -** The IRS has awarded a five-year contract to a partnership to implement a state- of- the- art inventory management system for its 70 warehouses which supply 750 field offices.

**Navy Shifts Jobs To Private Sector -** The U.S. Navy is planning to reduce costs by shifting services such as vehicle maintenance, data processing, and child care to the private sector.

**DOE To Issue Waste Water Cleanup -** The Department of Energy plans to issue an RFP for an environmental management contract, which will include cleanup work and waste management activities at several of the department's facilities, including three plants in Oakridge, Tennessee.

**Contract Monitoring and Evaluation** - As more governments rely on private companies to deliver public services, monitoring and measurements systems are becoming more refined. It is necessary to establish a monitoring plan before you contract. The better the performance standards, the easier it will be to effectively the monitor the contract. "The design of the deal can make an enormous difference in the future success of monitoring the contractor, says Tom Olsen, a private consultant formerly with the City of Indianapolis. "Strategic thinking on monitoring needs to begin at the time the deal is structured, not after." Such interdependence means it makes sense to write the performance standards and the monitoring plan simultaneously.

**"PRIVATIZATION IS A TOOL THAT CAN HELP PUBLIC OFFICIALS PROVIDE ESSENTIAL SERVICES IN A COST-EFFECTIVE MANNER. INTRODUCING COMPETITION AND PRIVATIZATION TO GOVERNMENT SERVICES REQUIRES REAL COST INFORMATION. PRIVATIZATION INCREASES COMPETITION AND COMPETITION INCREASES PRODUCTIVITY."**

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